Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

29 August – 4 September 2016

This week, we will see a lot of data releases from Poland, which might contribute to the continuation of last week's trend of zloty weakening, and have a positive impact on bonds. First, GDP for 2Q16 will confirm no growth acceleration with fixed investments in red. Actually, we expect the same in 2H16, which is below market consensus. Second, PMI data for August will be an important indicator of 3Q16 activity, after a sharp drop in July. Should the figure disappoint, the market may reinforce expectations for monetary policy easing. Finally, our flash CPI estimates for August show a deepening of deflation (to 1%YoY) and though temporary, it might be positive for the Polish bonds. Still, the Polish interest rates market will be driven by a combination of local and global factors. PMI and CPI data for Europe as well as US non-farm payrolls will be important in this regard, as they might affect the core bond market. Also, after the weekend the market will fully digest comments from Jackson Hole conference. On Friday Janet Yellen said that "the case for an increase in the federal funds rate has strengthened in recent months". This caused only a moderate short-term market reaction.

Moody's decision on Poland's rating (September 9th) will be another important element for the Polish market over the next two weeks. Last week, the agency released a short note saying that the recent escalation of the Constitutional Court row is credit negative as it is likely to increase tensions with the European Union, with a higher risk of further impairment of Poland's investment climate. Still, we do not think this will automatically translate into a rating downgrade and we do not expect it (our view is shared by 14 out of 19 analysts polled by Reuters on Friday).

Economic calendar

CZAS W-WA	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (29 August)					
14:30	US	Personal income	Jul	%MoM	0.4	-	0.2
14:30	US	Consumer spending	Jul	%MoM	0.3	-	0.4
		TUESDAY (30 August)					
10:00	**PL**	**GDP**	**Q2**	**%YoY**	**3.1**	**3.1**	**3.0**
16:00	US	Consumer confidence	Aug	pts.	97.0	-	97.3
		WEDNESDAY (31 August)					
11:00	EZ	Flash HICP	Aug	%YoY	0.3	-	0.2
14:00	**PL**	**Flash CPI**	**Aug**	**%YoY**		**-1.0**	**-0.9**
14:15	US	ADP report	Aug	k	173	-	179
16:00	US	Pending home sales	Jul	m/m	0.8	-	0.2
		THURSDAY (1 September)					
	CN	PMI manufacturing	Aug	pts.		-	
9:00	**PL**	**PMI manufacturing**	**Aug**	**pts.**			**50.3**
9:55	DE	PMI manufacturing	Aug	pts.	53.6	-	53.8
10:00	EZ	PMI manufacturing	Aug	pts.	51.8	-	52.0
14:00	US	Initial jobless claims	week	k		-	261
16:00	US	ISM manufacturing	Aug	pts.	52.0	-	52.6
		FRIDAY (2 September)					
9:00	CZ	GDP	Q2	%YoY		-	2.5
14:30	US	Non-farm payrolls	Aug	k	180	-	255
14:30	US	Unemployment rate	Aug	k	4.8	-	4.9
16:00	US	Industrial orders	Jul	%MoM	1.9	-	-1.5

Source: BZ WBK. Reuters. Bloomberg

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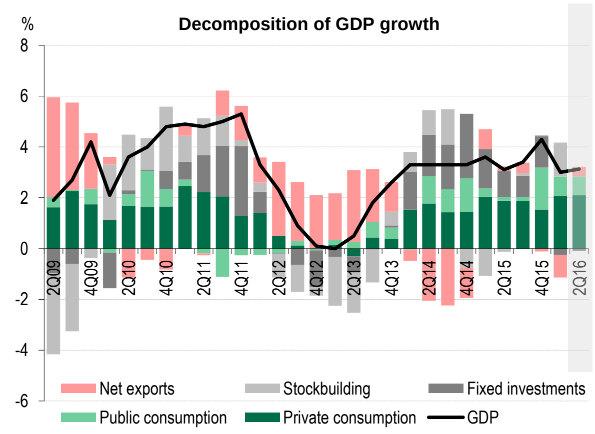
What's hot this week – GDP breakdown, flash CPI and PMI

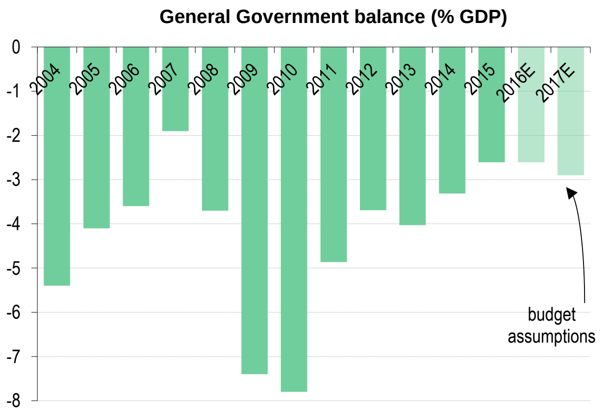


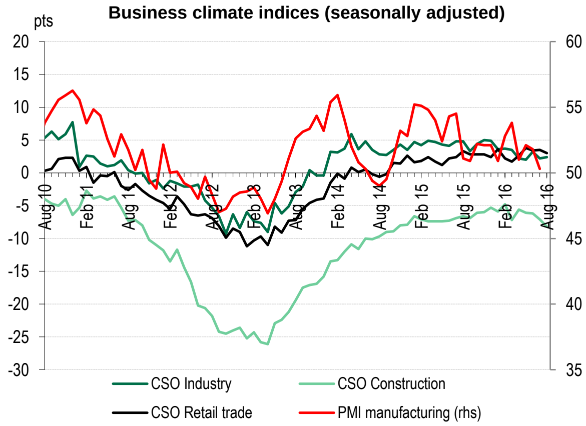
▪ This week, we will get to see the detailed GDP growth breakdown for 2Q16. We are expecting a quite robust growth in private consumption, a slightly positive contribution of net exports and a negative growth rate of investment. The Statistics Office is also likely to revise the earlier data. Recently, export balance in 4Q15 was revised strongly to the downside and, in our view, this may affect GDP growth.

▪ We estimate CPI in August at -1.0% y/y, slightly lower than in July due to high base effect in food prices. In our view, a gradual rise in CPI will begin in September and this measure is likely to be around zero at the year-end.

▪ After a considerable drop in PMI index in July to 50.3, we expect a slight upward rebound. In our view, the July's reading was overly pessimistic, but we do not see any factors that could push the gauge considerably up.

Last week in the economy – Draft budget for 2017, unemployment and leading indicators





▪ The government approved the draft budget for 2017. The central budget deficit was assumed at PLN59.3bn (3.1% of GDP), while the general government deficit at 2.9% of GDP, i.e. with surplus in the local government and social security fund. The budget takes into account lowering the retirement age in 4Q17 and withdrawal from VAT rate cuts. In general, the budget looks quite optimistic, especially as regards the economic growth projections (3.6%, which is both above the consensus and our projections) and tax income (8% growth, which is to be delivered largely by improvement of tax collection). In our opinion, the budget deficit is not unachievable; yet, we see some risk for its delivery.

▪ The registered unemployment rate fell in July to 8.6%, in line with our forecasts. We would like to stress the deepening fall in the number of people removed from unemployment rolls after taking up a job (-13.9% y/y), especially a non-subsidised one (-22.3% y/y), which is suggesting rising difficulties with filling vacancies and a possible deceleration of downward move in the unemployment rate in the future.

▪ The Statistics Office's business climate indicators for August showed a slight improvement in manufacturing, but a weakening in construction and trade. The indicator of new orders in the industry rose in July by 0.4% y/y and new export orders went up by 6.7% y/y. These numbers suggest a considerable deceleration of orders; in 1H2016, both indicators were rising at much faster pace, by 25% y/y and 30% y/y, respectively. In general, these gauges are not a good sign for the industrial output and economic growth. At the same time, the Statistics Office's data suggested a significant slackening of Polish exports in 1H2016.

Quote of the week – Is lower inflation target a good idea?

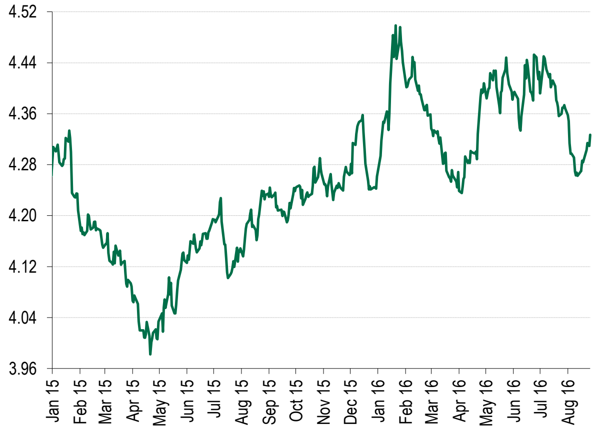
Kamil Zubelewicz, MPC member, 24 August, PAP
In my opinion, the current monetary policy is good for the Polish economy. Thus, we should not change its parameters to revive the economic growth. Stability of the monetary policy is the value itself. I think that a decrease of inflation target would improve confidence in the Polish economy by lowering the possibility of persisted elevated inflation.

Jerzy Żyżyński, MPC member, 26 August, Rzeczpospolita
A rates cut from the current level would not be very effective. The problem does not concern the central bank rates, but the interest on loans for companies. Even though it has fallen considerably over the last years, it still remains relatively high. The banking system overliquidity is a proof that loans are too expensive for potential debtors. I think that the central bank should limit its absorption of overliquidity in order to make commercial banks use it.

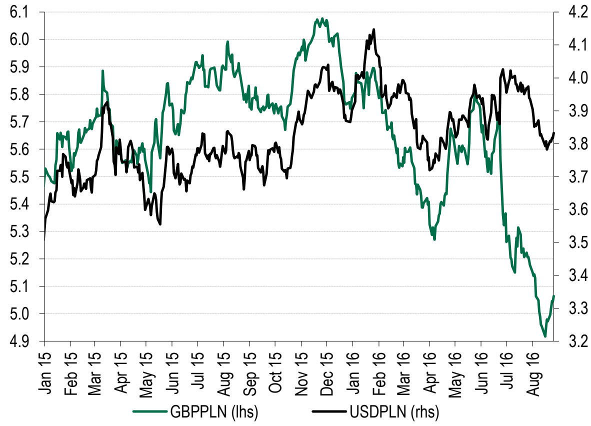
According to MPC's Zubelewicz, decrease of the CPI target is a good idea as it would mitigate the risk of an increased inflation and enhance confidence in the Polish economy. Zubelewicz seems to be a radical hawk, so his views do not represent the consensus within the Council. As regards the CPI target, it would be a bad idea to decrease it with inflation running persistently below the target. Such a decision could contribute to the consolidation of deflationary pressure in the economy and would threaten the central bank's credibility. Zubelewicz claims that "stability of the monetary policy is the value itself". However, we think that ad-hoc adjustment of the long-term target to the current situation to keep rates unchanged does not attest to a stable policy. On the other hand, J. Żyżyński, recently speaking about possible cuts, said now that interest rate cut would be not very effective. In his view, the central bank should limit absorption of banks' overliquidity in order to make them increase credit action. Żyżyński also claimed that interest on loans for companies is high. We do not understand this comment as, actually, margins on these loans in 1H2016 were lower than on average in the 2010-2016 period and comparable with the euro zone.

Foreign exchange market – Fed policy outlook overshadowing domestic news

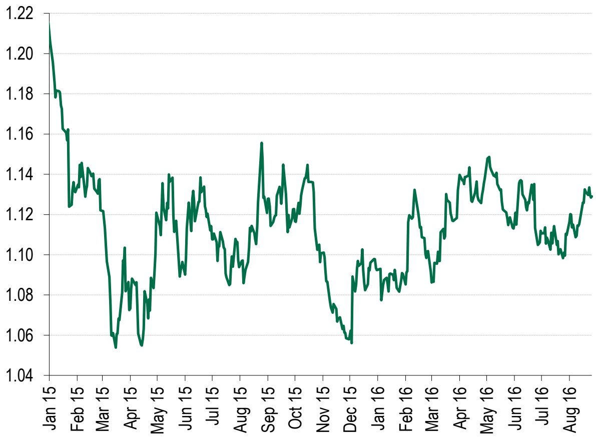
EURPLN



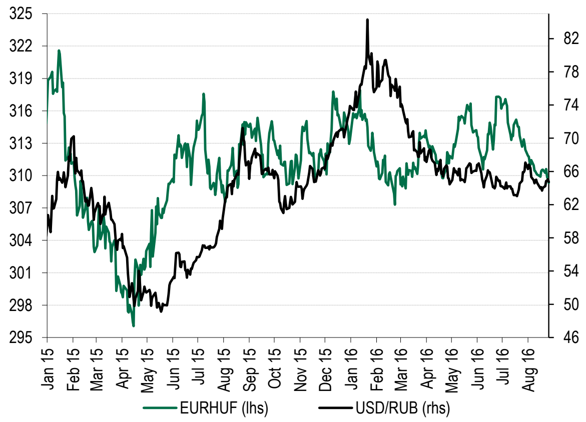
USDPLN and GBPPLN



EURUSD



EURHUF and USDRUB



More room for zloty depreciation?

- Polish foreign exchange market was extremely stable over the last week with EURPLN hovering near 4.31 for most of the time, as investors were awaiting the central bankers' annual summit in Jackson Hole. There were very few important news and data releases. Only at the end of the week a bit more significant move was reported as the EURPLN rose to 4.33 on Thursday afternoon. This could have been triggered by the speculation about potential rate cuts after recent MPC members' comments and the release of the MPC minutes, as well as the Moody's warning that the deepening constitutional crisis in Poland is credit-negative and may harm the economic growth and the investment climate (however, the latter info appeared after the session's close). The zloty depreciated slightly versus the US dollar and the British pound, as both currencies gained strength against the euro at the beginning of the week.
- We see higher risks of PLN depreciation than of its strengthening in the coming weeks. The zloty may suffer from both global and local factors. The former include looming Fed rate hike before the year-end, and the latter comprise disappointing economic growth, continuing speculation about potential rate cuts, and uncertainty regarding rating decisions (which may increase after the Moody's note – the agency is scheduled to review Poland's rating on September 9th).
- The long-awaited Janet Yellen's speech gave little guidance as regards timing of the Fed's rate hikes, but many US data releases next week may be important in this regard and the zloty may be vulnerable to this information. Polish data to be released in the coming days (GDP, PMI) may be unsupportive for the zloty, which in our view, confirms little chance for the economic growth rebound in 3Q16.

No clear impulse for EUR/USD from Yellen's speech

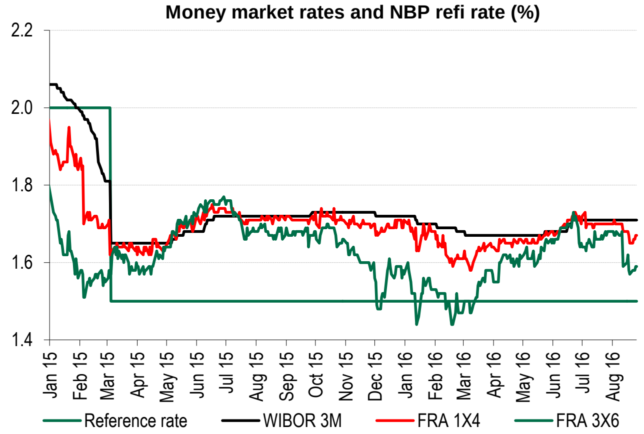
- The dollar gained strength at the start of last week, supported by the strong data from the US economy and comments of several Fed officials who suggested that interest rate hike may be on the cards soon. The probability of the FOMC rate hike in September priced-in by Fed futures has risen recently above 30%, its record high since the UK's Brexit referendum. After the initial drop to 1.125, the EUR/USD was gradually climbing in the remainder of the week, returning to 1.13 on Friday, as investors were awaiting the inaugural speech of Fed's president Janet Yellen at the Jackson Hole conference, hoping it will deliver more clarity on whether US interest rates will rise this year.
- The short-term reaction to the speech was positive for the dollar amid stronger arguments for the rate hike, but the EURUSD rose again after a suggestion that actions by the US central bank will be gradual. The Jackson Hole conference will end during the weekend and we will have to wait until the next week to see who the market participants digest all the central bankers' comments

Forint gained, ruble depreciated

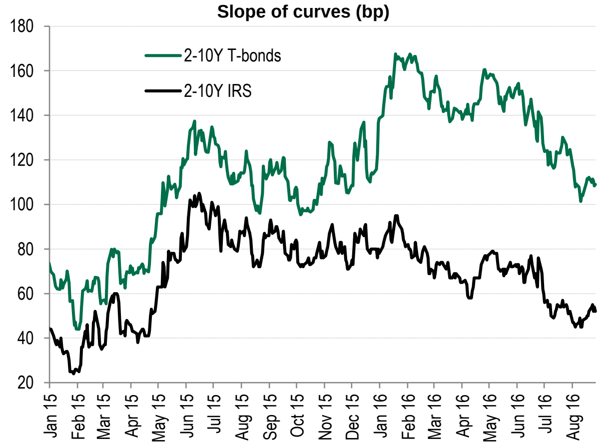
- Fluctuations on other foreign exchange rate markets in the region were also quite limited ahead of the central bankers' summit in Jackson Hole. Hungarian forint was one of the best performing emerging markets' currencies last week, even though it temporarily lost some ground after the Hungarian central bank meeting. The EUR/HUF fell to 308.5 on Friday from the weekly high at almost 310.8, gaining c0.7%. Meanwhile, the Russian ruble depreciated versus dollar amid lower crude oil prices.
- In the upcoming week, the news from the global economy, in particular quite numerous data releases in the USA, will remain key for the currencies in the region.

Interest rate market – More arguments for curve bullish steepening?

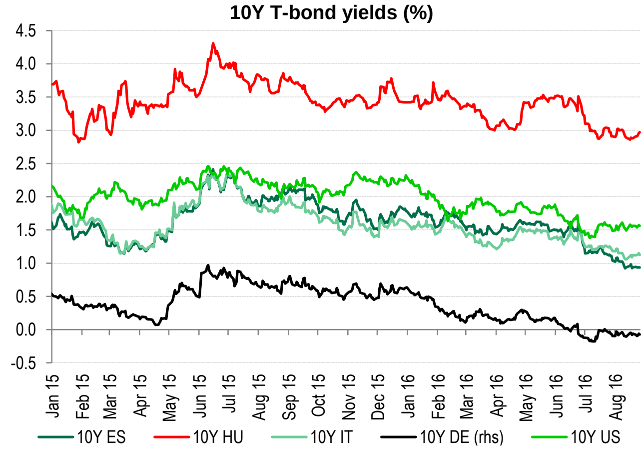
Money market rates and NBP refi rate (%)



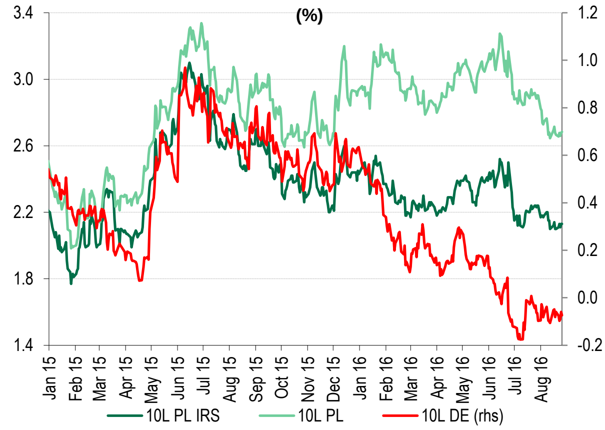
Slope of curves (bp)



10Y T-bond yields (%)



Yields of PL and DE 10Y benchmarks and 10Y PL IRS (%)



Rates stable ahead of the Yellen's speech

- The volatility and activity on the Polish interest rate market was very low as the entire week passed in expectation for the Friday's Jackson Hole conference.
- WIBOR rates remained unchanged, while FRAs increased slightly as investors were digesting recent comments of Polish central bank officials (Żyżyński who last week advocated interest rate cut, now claimed it would be ineffective, while Zubelewicz strongly opposed any policy easing and suggested that the inflation target could be reduced).
- Bond yields were stable for the better part of the week, even though the core debt markets saw yields creeping up ahead of the Janet Yellen's speech on Friday.
- Poland has successfully launched the so-called panda bonds worth Rmb3bn (PLN1.7bn), being the first European country to issue debt on the China's mainland bond market. The yield of the three-year bond reached 3.4%, i.e. -0.17% after a swap to EUR. Piotr Nowak, Deputy Minister of Finance, said that the Ministry counted on expanding the base of investors in Polish bonds in various currencies.

New data supportive for Polish bonds

- Domestic data to be released this week may be positive for bonds. First, GDP for 2Q16 will confirm no growth acceleration with fixed investments in red. Second, PMI data for August will be important indicator for activity in 3Q16, after a sharp drop in July. Should the figure disappoint, the market expectations for monetary policy easing may strengthen. Finally, we estimate flash CPI for August to show a deepening of deflation (to -1%YoY) and although it will be only temporary drop, it might fuel speculation about possible policy easing later this year.
- As the summer holidays are coming to an end, we may see more comments from Polish central bank representatives. It seems that currently most of the MPC members do not support further policy easing. However, consensus in the central bank may start changing if next economic data keep disappointing. We think that growing speculation for more interest rate cuts in Poland may trigger bull-steepening of the yield curve.
- The Polish interest rates market may also react to publications abroad. PMI and CPI data for Europe will be important in this regard, as they might affect the core bond market. US data releases will be also in focus, shaping expectations about FOMC policy outlook.

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